Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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In the Matters of	)	
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Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit	)	
	)	
Bell Atlantic (North) Telephone Companies' Continuing Property Records Audit	)	
	)	
Bell Atlantic (South) Telephone Companies' Continuing Property Records Audit	)	CC Docket No. 99-117
	)	ASD File No. 99-22
Bell South Telecommunications Continuing Property Records Audit	)	
	)	
Pacific Bell and Nevada Bell Telephone Companies' Continuing Property Records Audit	)	
	)	
Southwestern Bell Telephone Company's Continuing Property Records Audit	)	
	)	
US West Telephone Companies' Continuing Property Records Audit	)	

AMERITECH COMMENTS

Ameritech submits the following comments in the Commission's Notice of Inquiry on certain property record accounting practices of Ameritech.[1] While Ameritech appreciates the need for a full public record in this proceeding, we urge the Commission to expeditiously reject the Accounting Safeguards Division's (ASD) flawed audit recommendations before it and conclude its Continuing Property Record (CPR) inquiry.

[1] See In the Matters of: Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit et al, CC Docket No. 99-117, ASD File No. 99-22 Notice of Inquiry, released April 7, 1999, the "CPR NOI"; See also Public Notice released April 7, 1999, The Accounting Safeguards Division Releases Information Concerning Audit Procedures for Considering Requests by the Regional Bell Operating Companies to Reclassify or "Rescore" Field Audit Findings of Their Continuing Property Records, DA 99-668, the "CPR Public Notice"; See also Order, DA 99-1072, released June 2, 1999; Order, DA 99-1321, released July 2, 1999; Order, DA 99-1855, released September 10, 1999.

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The Commission should then focus its resources on simplifying and streamlining the CPR rules in the spirit of the pro-competitive and deregulatory framework envisioned in the Telecommunications Act of 1996.

A careful review of the ASD's audit procedures demonstrates how seriously they were flawed. For example, Ameritech is including with these comments a declaration from Arthur Andersen LLP (AA) which shows that the ASD's reliance on generally accepted government auditing standards (GAGAS) is misstated and unavailing in validating the legitimacy of the ASD's audit process, conclusions, or recommendations. Together with the flaws in the statistical methodology used by ASD related to sampling design, technique, and logic, AA shows that ASD's failure to perform corroborating testing of Ameritech's internal CPR controls and ledger account balances cannot provide a reasonable basis for rendering an opinion on the fair presentation, in all material respects, of Ameritech's COE account balance (See Attachment A, Declaration of Mr. Carl Geppert of AA, "Arthur Andersen Declaration"). Use of authoritative standards and practices pursuant to generally accepted auditing standards (GAAS) are necessary for rendering such an opinion.

AA further shows that the audit procedures performed by ASD and the standards and methodology to rescore items were both inadequate and incomplete because pertinent evidential matter was not given full, complete, and consistent assessment by ASD. This failure also emanated in part from ASD's failure to review Ameritech's internal CPR controls and also from a limited and restrictive use of 'probative evidence'. Ameritech is also including comprehensive documentation which shows that the ASD was neither consistent nor complete in their rescoring (See Attachment B)[2].

While, certain AA factual conditions are unique to Ameritech (i.e. a 1997 purchase of used and useful functioning investment from Sprint categorized as Undetailed Investment), independent auditors' findings throughout the industry mirror AA's conclusion regarding ASD's audit procedures and process. The Commission should assign great weight to these similar objective conclusions reached by independent audit firms engaged by other carriers subject to the same CPR audits with respect to the deficiencies of the ASD CPR audit.[3] Based on these independent expert conclusions, it simply strains credibility to accept the Audit Report's recommendations given the deficiencies of the ASD audit procedures and unreliability of the audit results. In short, the Audit Report's conclusions and recommendations should not be adopted by the Commission.

I. INTRODUCTION AND SUMMARY

On January 11, 1999, Ameritech submitted its response to the ASD's December 22, 1998 Draft Audit Report ("Audit Report") of Ameritech's CPR ("Ameritech's Response")[4]. On March 12, 1999, the Commission released the Audit Report and an

[2] See Attachment B, Ameritech's analysis of ASD's scoring inconsistencies and ASD's failure to recognize underlying support documentation for changed scoring results. The last three sentences of footnote 4 in these comments also applies to Ameritech's use of Attachment B.

[3] See January 11, 1999 responses of Bell Atlantic, "Bell Atlantic Response"; SBC Communications, "SBC Response"; US West, "US West Response"; BellSouth, "BellSouth Response".

[4] Ameritech's Response of January 11, 1999 was revised on February 17, 1999 to correct information related to the $109M of telecommunications plant purchased from Sprint. Attachment C is Ameritech's Response of February 17, 1999, masked of confidential central office location and vendor pricing information. Such information is not necessary for purposes of addressing Issue No. 2 in this proceeding. By attaching certain masked submissions previously made in response to the ASD's Audit Report, Ameritech does not waive its claim that such materials generally qualify for confidential treatment under FOIA exemption 4 and Section 0.457 (d)(iii) of the Commission's rules (see Ameritech's Opposition to MCI Worldcom's FOIA request by July 12, 1999 letter from Leander R. Valent, Counsel for Ameritech to Andrew S. Fishel, FCC Managing Director). Further, while Ameritech maintains its position that Issue No. 2 of the CPR Public Notice does not require public disclosure of information other that that contained in previously disclosed audit reports (see Ameritech's Application for Review (AFR) of the Common Carrier

abbreviated version of Ameritech's Response. (See In the Matter of Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit, ASD File No. 99-22, Order, released March 12, 1999, ("CPR Order").

Following the CPR Order, the Commission initiated this NOI proceeding to seek comment on ten issues ranging from the statistical sampling methodologies to the benefits of compliance with FCC CPR rules[5]. Ameritech's Response addressed in full all of the substantive issues pertaining to the validity (or lack thereof) of the audit's findings and recommendations. Therefore, Ameritech's comments in this proceeding are focused primarily on new issues not previously addressed. To ensure a complete and accurate record, Ameritech is incorporating its entire Response with all appendices as part of its Comments in this proceeding (See Attachment C).

A. Summary of Ameritech's response to the Audit Report.

As Ameritech demonstrated in its Response to the Audit Report, the conclusions reached by ASD are flawed and the audit results cannot be relied upon to form an opinion on the fair presentation of Ameritech's assets. In addition, the recommendations to engage an independent firm to conduct a complete inventory of central office equipment (COE) and to write-off $566.7 Million (M) of COE investment are unwarranted and premature.[6] Specifically, Ameritech's Response showed the following:

1) The ASD's Audit Report on Ameritech's continuing property records (CPR) is fatally flawed, the recommendations have no basis, and the results cannot be relied upon to opine on the fair presentation of Ameritech's investment balances.

Bureau's (CCB) Action Granting MCI Worldcom's FOIA Request, pp. 4-6), the contrary finding of the CCB, and MCI's opportunity to review similar Bell Atlantic audit submissions cause Ameritech to address not only the scoring methodology used by the ASD, but also the specific application to Ameritech's CPR items. Ameritech has masked all confidential information to avoid the need to file the Attachment C under protective cover or seal, and it expects that other commenters will have ample opportunity to fully address Issue No. 2 in the already extended pleading cycle.

2) Even if the allegations were true (which they are not), there would be no impact to customers and no justification for any reduction of Ameritech's rates.

3) Auditing or scoring standards used by ASD on the adequacy of supplemental information supplied by Ameritech subsequent to the physical inventory were improper because they were too narrow in scope and application, were inconsistently applied, and were not completely assessed.

4) As a result of the ASD's improper auditing approach and practices, Ameritech engaged Arthur Andersen LLP (AA) to perform an independent review of the ASD's audit process and results. AA concluded that the audit processes were deficient because the ASD did not use (GAAS). An adjustment to financial statements is only supportable in cases where an audit in accordance with GAAS is performed. Because ASD's audit failed to comply with GAAS, it cannot be relied upon to justify any such adjustments. AA also concluded that the statistical methodology used by ASD for sample design and extrapolation was inaccurate and unreliable. Moreover, AA's efforts to corroborate ASD's statistical methodology using Bayesian methodology failed to validate the results.

5) AA found many items the FCC scored as "not found" and Ameritech provided supporting documentation on certain items where the FCC scoring was inconsistent. The ASD largely ignored both Ameritech's and AA's validations. The Audit Report however, includes items scored a "2", i.e. items matching the CPR description but found in a different location within the central office, as part of the 23.3 percent of records alleged to be seriously deficient.[7] This narrow and unrealistic interpretation is arbitrary and capricious. There is nothing in the

[5] See CPR NOI at 3-4.
[6] See also Ameritech's August 26, 1998 response to the ASD's draft audit report of July 27, 1998.

Commission's rules, or common language usage, that justifies classifying an item that is 'found' as 'unverifiable'; nor does ASD attempt to (nor could they) explain how items that were found are nonetheless "unverifiable". However, reporting the audit results as a percentage of investment and incorporating Ameritech's and AA's validations results in items scored as "not found" of about 4 percent, which is not unreasonable given the constrained time frame in which Ameritech and AA had to evaluate the audit results.

6) The Audit Report's inclusion of Undetailed Investment is wrong because: (i) it is a term in use for over thirty years and represents used and useful investment predominately associated with analog technology, (ii) nearly half of the alleged overstatement of $260.7 M, or $109 M, is plant purchased from Sprint in 1997, which is functioning used and useful investment and, (iii) Ameritech has reduced the amount of this investment over 75 percent in the last five years from $555 M in 1993 to $ 138.8 M as of August 31, 1998, excluding the plant purchased from Sprint.

7) Relying on the 1994 audit to conclude that Ameritech's CPR problems are "longstanding" and "deeply ingrained" is unfounded because the 1994 audit indicated that nothing led the FCC auditors to conclude that Ameritech was not in compliance with its CPR rules.

8) As a result of these serious flaws, the Audit Report's recommendations, including the write-off of inventory, are improper and unnecessary. As a result, Ameritech: objected to (i) ASD's recommendation to write-off $306 M of COE hardwire investment based on faulty FCC audit procedures and results, (ii) write-off $260.7

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[7] See Audit Report at Page 9, Table 2.

M of Undetailed Investment, of which $109 M was investment recently purchased from Sprint and, (iii) inventory its entire COE which could take over five years, 700,000 man hours and cost over $35 M.

B. Summary of Ameritech's Comments to this NOI.

The fundamental issue in this NOI proceeding is, once again, whether the procedures used by ASD were sufficient to form an opinion on the fair presentation of Ameritech's COE plant balances for which a write-off of $566.7 M is recommended. The answer to that issue is, once again, they were not.

As summarized above, Ameritech's Response showed that ASD's procedures were both seriously flawed and deficient and provide no reasoned basis for any such recommendation. Therefore, the Commission need not reach conclusions on most of the issues raised in the CPR NOI to quickly conclude this proceeding and terminate any future activity on these audits. The bottom line is this: the Commission should terminate this proceeding on the most basic fundamental principle that the audit procedures used were deficient. Issues surrounding the validity of the statistical methodology, or the sufficiency of the degree of error in the CPR records, and other such matters raised in the CPR NOI are secondary and need not be resolved given the failed starting point of deficient audit procedures. However, as shown below, if the Commission address the issues in its NOI, it becomes even more clear that the Commission can not adopt ASD's audit recommendations. Finally, even if the proposed audit procedures and recommendations were valid, and they clearly were not, Ameritech's Response and Comments demonstrate that there has been no impact on Ameritech's retail or wholesale customers to justify any reduction of Ameritech's current rates.

In these Comments, Ameritech responds to each of the NOI issues. In summary, Ameritech demonstrates that:

1) ASD's reliance on GAGAS is misstated and unavailing and rescoring was neither complete nor consistent. An analysis of the ASD audit results shows that all documentation was neither fully considered nor consistently applied. ASD's failure to conduct a review of the internal processes and controls, contrary to GAAS, led to the failure to establish and justify any standard for the evaluation of Ameritech provided documentation.

2) The statistical sampling methodology used by the ASD is both invalid and unreasonable as shown by several independent audit firms and cannot be relied on. Fundamentally, the sample design was inappropriate to produce an extrapolated estimate of the dollar investment of plant account balances due to an unknown degree of error and significant bias attributable to the ASD's audit plan deficiencies.

3) There is no ratemaking impact resulting from the CPR audits principally because any delay in a book retirement of an asset has no impact on net investment (original cost of assets less accumulated depreciation), or rate base. Similarly, there is no measurable impact on depreciation expense because of the self-correcting mechanism of the remaining life depreciation methodology.

4) There is no adverse ratepayer impact on calculations relating to universal service support and the pricing of unbundled network elements. With respect to universal service support, Ameritech does not receive any Dial Equipment (DEM) Weighting and is not eligible to receive Long-Term (LT) Support Payments. Existing High Cost Loop Fund Support is determined on the basis of net plant and any delayed retirements associated with any alleged plant overstatements have no impact on net plant. Future

High Cost Loop Fund Support will be/are determined on the basis of forward-looking costs as opposed to embedded or CPR type booked costs. Where the determination of plant specific expenses use the relationship of expense to embedded investment as a starting point in the calculation of forward-looking costs, any alleged overstatement of plant, holding averaging and other considerations constant, results in lower maintenance factors, lower costs per loop, and less entitlement to fund support. Also, contributions do not rely on investment information. Rather, contributions to the High Cost Loop Fund are based on revenues. As a result, there is no adverse ratepayer impact for either contributions to or payments from the High Cost Loop Fund.

Similarly with respect to the pricing of unbundled network elements, there is no adverse ratepayer impact associated with any alleged plant overstatement. Ameritech uses long run economic cost principles to determine its Long Run Service Incremental Costs (LRSICs) and the FCC requires the use of Total Element Long Run Incremental Costs (TELRICs) for unbundled elements. Embedded or CPR type booked costs are not incremental and are excluded from the studies. Where the determination of cost factors rely on investment balances, in instances such as development of maintenance factors and ad valorem tax factors, any alleged plant overstatement results in a lower maintenance factor and lower costs. As a result, if anything, the cost studies would have understated maintenance and property tax costs with no adverse impact on any customer rates.

5) The conclusions reached in the 1994 audit of Ameritech by ASD do not support the conclusions reached by ASD in 1997 that Ameritech has a "longstanding" and "deeply ingrained" CPR problem. Specifically, the preliminary conclusion of the 1994 audit was that nothing led the auditors to conclude that Ameritech was not in compliance with the Commission's CPR rules. Only 3 percent of the COE hardwired

records were alleged to be deficient, which in the case of a going concern is not unreasonable. Further, there is no justification for extrapolating the ASD's physical verification test results to prior, or future periods, particularly since the ASD did not review Ameritech's internal controls throughout the period under review.

II. NOTICE OF INQUIRY ISSUES

Issue 1: The validity and reasonableness of the statistical sampling methodologies used by the auditors, including: sample design, the two-stage stratified sampling technique, balance and adjustments made to account for high-cost and lower-cost items, the audit procedures, extrapolation techniques, confidence intervals, and the application of Bayesian techniques.

The carriers audited by the ASD engaged independent firms to assess the validity and reasonableness of the statistical sampling methodology. The similar conclusions reached by the independent firms show that the ASD's statistical sampling methodology is both invalid and unreasonable and as a result cannot be relied on.[8] Specifically, the flaws in the statistical methodology include the following:

1) The 'attribute sampling' design used by ASD was inappropriate to produce an extrapolated estimate of the dollar investment of plant account balances. Rather, the sampling design could only be used for measuring items on the CPR not found and not the dollar value of any missing items. The sampling design was not established to evaluate dollar values of investment.

2) The ASD's failure to incorporate testing for possible understatements in the CPRs (i.e. a two-way audit) in the audit plan results in biased results.

[8] See Ameritech Response at Page 8 and Affidavit of Carl Geppert of Arthur Andersen LLP at Appendix A-0; See Arthur Andersen Declaration at Page 7; See Attachment C at Appendix A-5, Affidavit of Paul Charnetzki; See also SBC Response at Page 11 and Statement of Ernst & Young LLP at Appendix B; See US West Response at Page 14 and Statement of Deloitte & Touche LLP; See Bellsouth Response at Page 18 and Ernst & Young LLP review, See Bell Atlantic Response at Page 11 and Ernst & Young LLP review at Appendix A.

3) The sampling contained an unknown degree of error attributable to the exclusion of offices in the sampled population, no ASD revisits to any selected offices, ASD substitution of sampled items, a restrictive amount of time to locate the items, the exclusion of items found subsequent to the ASD field visits, and the exclusion of items for which supporting documentation was subsequently provided to ASD by the company.

4) ASD used a cluster sample with an inaccurate variance calculation and not a two-staged stratified sampling technique.

5) While insufficient information was provided by ASD to assess the merits of the Bayesian techniques used, it is unlikely that the defects identified in the sample design, implementation, technique, or logic would be corrected with the use of this technique.

ASD's failure to use the appropriate statistical methodology to properly account for higher-cost and lower-cost items results in a mischaracterization of findings and unsupportable recommendations. The reperformance verification conducted by AA, together with Ameritech's revisions related to inconsistent scoring, results in an extrapolated amount of $182.6 M.[9] Further, given the deficiencies associated with ASD's sample design and implementation detailed by AA, there is no basis to extrapolate beyond the lower bound of the point estimate of $93.7M.[10]

Ameritech emphasizes however, that the extrapolated amounts do not represent plant overstatements. Rather, such restated amounts are shown only to demonstrate that within a constrained time frame, Ameritech was able to reduce the alleged plant overstatement by 50 percent. This 50 percent reduction, in and of itself, demonstrates both that the audit procedures and results are flawed.[11]

Also, incorporating AA's and Ameritech's corrections to the Audit Report, and displaying the results as a percent of investment and not line items, shows, that about 96

[9] This amount would need to be restated downward to reflect the ASD rescoring between the July, 1998 draft audit report and that contained in the Audit Report. See Arthur Andersen Declaration at Page 14; See also, Ameritech Response at Appendix A-0 at 5; Attachment C at Appendix A-1 at 4;Attachment C at Appendix A-4, at 6; Attachment C at A-5, at Attachment 2.
[10] See ibid. at footnote 9.

percent of the total investment was found. Again, given the constrained time frame, this is not an unreasonable percent for a corporation with $6 B in COE hardwired assets and 62 M individual pieces of equipment.[12] Similar analyses conducted by other companies under audit showed similar results: SBC, 97 percent;[13] Bell Atlantic, 97 percent;[14] US West, 96 percent[15]; BellSouth, immaterial estimate of missing equipment.[16]

As a result, the analyses conducted by each of the companies under audit and several independent accounting firms show that the statistical sampling methodology used by the ASD is both invalid and unreasonable and cannot be relied on. This conclusion alone justifies an expeditious close to this proceeding.

Issue 2: The validity and reasonableness of the methodology used by the Bureau's auditors in determining whether to rescore or to modify a finding during a field audit that equipment was "not found".

Concurrent with the CPR NOI, the Commission released a Public Notice on the process used to verify the accuracy of the CPRs and the procedures used to rescore specific items.[17] The information contained in the CPR Public Notice fails to validate the legitimacy of the ASD's audit scoring process, results, or recommendations.

A. <u>ASD's Auditing Standards Were Deficient</u>

[11] See Ameritech Response at Page 8.
[12] See Ameritech Response at Page 7; the restated figure of 96 percent is remarkably close to the ASD's audit results of Ameritech's CPR conducted in 1994, where the ASD found no reason to believe Ameritech was not in compliance with the Commission's CPR rules.
[13] SBC Response at 25.
[14] Bell Atlantic Response at 4 and Exhibit 1.
[15] US West Response at 12.
[16] BellSouth Response at 22.
[17] See CPR Public Notice released April 7, 1999; See also CPR NOI at footnote 2 designating this matter Issue 2.

ASD's reliance on GAGAS is misstated and unavailing.[18] As described in the declaration of Mr. Carl Geppert of AA (Attachment A), GAGAS is a set of standards describing how the government and related agencies and entities should be audited and not how the government should perform an audit. Rather, GAAS are the standards on which audits performed for the purpose of reaching conclusions on the fair presentation of the financial information, which was the subject of the audit, should be based, i.e. COE plant account balances and recommendations related to such balances.[19]

The audit deficiencies identified by AA include the following:[20]

1) No corroborating testing of account balances or other financial statement accounts.

2) The lack of review of internal controls over the hardwired COE CPRs.

3) The failure of ASD to communicate its standards prior to the release of the CPR Public Notice.

4) A nearly exclusive reliance on physical inspection as the only competent evidential matter considered.

5) The limited communication with Company management as a source of audit evidence and to validate audit results.

6) The lapse of time between the date of the sampled report and the physical verification.

7) The limited and restrictive field audit procedures.

8) The lack of follow-up field visits to verify items found subsequent to the one-day physical audits.

9) The restricted review afforded companies to comment on the draft audit findings.

[18] See CPR Public Notice at 1.
[19] See Arthur Andersen Declaration at Page 3.
[20] See Arthur Andersen Declaration at Pages 3-7; See also Ameritech Response at Page 4; See also Attachment C at Appendix A-0 at 2-3; Appendix A-1 and Appendix A-3, Affidavits of Carl R. Geppert; See also SBC Response at Page 14; BellSouth Response at Page 12; US West Response at Pages 8-9; Bell Atlantic Response at Pages 9-12.

These deficiencies in the ASD's audit process render the conclusions and recommendations of ASD unreliable.[21] Conclusions and recommendations with respect to the fair presentation of account balances can only be made pursuant to authoritative standards and practices --GAAS.

B. ASD's Rescoring was Neither Complete Nor Consistent

Ameritech engaged AA to evaluate certain aspects of the ASD's draft audit report issued to Ameritech on July 27, 1998. Included in AA's evaluation was a reperformance of physical verification procedures and review of supplemental information in cases where the ASD either could not find certain equipment items or could not verify that items found were the specific items listed in Ameritech's CPRs.

Through AA's physical verification procedures, AA was able to substantiate the existence of certain COE equipment items coded as "not found" by the FCC.[22] AA performed the following procedures when physically verifying the disputed property items after meeting with Ameritech COE engineers to gain an understanding of each disputed property item's description:

> 1) Compared the physical appearance of the item to the disputed property item's CPR description as available.
>
> 2) Compared the actual physical location and quantity of the disputed property item to the location and quantity on the CPR.
>
> 3) Assessed the reasonableness of the physical state of the disputed property item given the vintage year indicated on the CPR.
>
> 4) Obtained a signed statement from the on-site engineer at each location attesting to the valid existence of the disputed property items at that specific central office location.
>
> 5) Counted the total number of items in the central office that matched the disputed property item description and compared it to the total number of items listed under the CPR number related to the disputed property item.

[21] Arthur Andersen Declaration at Pages 2-3.

[22] See Attachment C at Appendix A-4.

6) Photographed the disputed property item that was physically verified during AA's on-site visit.

Furthermore, Ameritech's analysis of the ASD rescored physical verification results, which form the basis of the Audit Report, shows that there are continued scoring inconsistencies and an incomplete consideration of supplemental information submitted by Ameritech (See Attachment B). This analysis and documentation shows categories of multiple instances where ASD did not rescore an item where the probative evidence meets any conventional auditing practice. These categories consist of: (i) instances where Arthur Andersen physically verified the existence of the equipment as evidenced by photographs, (ii) validation of correct CPR dollars with CPR quantity errors and, (iii) identical documentation submitted to ASD with different ASD scoring results. Support for these instances as documented in Appendix B consisted of physical verifications, supplemental vendor price and cost information, and engineering drawings.

Ameritech again submits that the results of both AA's and Ameritech's rescoring shows that the ASD alleged overstatement was reduced by 50 percent within the constrained timeframe of ASD's release of the draft audit report of July 27, 1998, and Ameritech's response of August 26, 1998, to the draft. This reduction, in and of itself, demonstrates the ASD's audit deficiencies and the unreliability of the results and recommendations.[23]

Contrary to the CPR Public Notice, the audit results show that ASD largely ignored the reperformance verification conducted by AA and neither fully considered nor consistently applied their standard for rescoring an item.[24] In order for an item to be rescored, Ameritech was required to submit evidence with the probative value equal to

[23] See Ameritech Response at Page 8.

the physical inspection. This standard however, i.e. probative value equal to the physical inspection, is arbitrary and lacks grounding in the professional standards.[25] Valid evidential matter must also include (i) evidence obtained from independent sources outside the entity and, (ii) evidence obtained from the company, particularly when the auditors have evaluated the effectiveness of internal controls. Ameritech submits that both of these additional criteria on the validity of evidential matter were excluded from the ASD audit plan and execution. There was no ASD review of internal control procedures. There was no ASD acceptance of the physical inspection results of AA. There was no physical re-verification by ASD when company provided documentation suggested that ASD's initial physical verification efforts were erroneous or at least questionable.

Instead, ASD relies on GAGAS to assert that physical inspection is the best evidence with which to verify that an item was accurately recorded on the CPR.[26] Best evidence however, is not equated with exclusive reliance under GAGAS as was the case with ASD's scoring process.[27] Nor is this the only procedure to rely upon for purposes of drawing conclusions as to the fair presentation of the value of assets recorded within the books and records of Ameritech. The GAGAS quoted in the CPR Public Notice also includes computation and inspection as competent evidence, which involves using corroborating information, apart from physical inspection, to verify that an item is accurately recorded. ASD misstates GAGAS to equate physical inspection, which occurred in a constrained time frame with no physical reverification, as the exclusive test for verification of an item and ignores the validity of other evidential matter.

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[24] See also SBC Response at Pages 21-25; BellSouth Response at Pages 13-18; US West Response at Pages 11-13; Bell Atlantic Response at Exhibit 3.
[25] See Arthur Andersen Declaration at Pages 11-12.
[26] CPR Public Notice at 1.

With respect to what documentation ASD considered acceptable for re-scoring any particular item, Ameritech was unaware of the standards used by ASD during the course of the audit despite multiple attempts to obtain ASD criteria. No standards used by ASD were communicated to Ameritech prior to the release of the CPR Public Notice. No ASD workpapers, notes or scoring sheet details were ever shared with Ameritech at any time. While ASD apparently considered source documents with cost amounts, signatures, dates, and other such evidence convincing in some instances, computer generated lists were not.[28] ASD's failure to review the company's internal controls, an audit deficiency in and of itself, also led to the failure to establish and justify any standard for the evaluation of computer generated support documentation.[29]

For example, ASD did not consistently consider computer generated asset purchase documentation which Ameritech submitted, despite the fact that the inputs for this documentation are directly from the equipment vendor according to TelCordia's national file format standards, which are intended to replace original invoices with signatures. TelCordia's standards recognize the following documentation:

(1) Electronic Data Interchange Process (EDI)

> TelCordia Description: The corporate electronic data interchange (EDI) process permits Ameritech to accept VENDOR TRANSMISSIONS OF INVOICES and order acknowledgments intended for PICS/DCPR. This run is designed to process a fixed-length, flat file, containing either/both purchase order acknowledgment transactions (855) or invoice transactions (810), and to direct these transactions to multiple output files for different application processes. (EMPHASIS ADDED)
>
> *The purpose of the EDI processor run is to allow any of Ameritech's vendors to transmit orders and/or invoices in a standard, industry-defined formatted file.(emphasis added)*
>
> These equipment orders may represent the hardwired equipment details being installed in a new central office location, updates to existing equipment requisitions, etc. These equipment details are associated with a requisition and

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[27] See Arthur Andersen Declaration at Pages 10-13; See also US West Response at Page 6.
[28] See CPR Public Notice at 2.
[29] See Arthur Andersen Declaration at Page 12

authority and may be further divided by a vendor order number and vendor specification number. The invoices represent dollar amounts and quantities associated with the equipment orders. Invoices may contain information on the hardwired, plug-in or repair orders within the PICS/DCPR system.

Loading invoices using the mechanized process eliminates the need for the vendor to send paper invoices to Ameritech and for Ameritech to manually enter these invoices on-line. Fewer errors are entered into the system when the mechanized process is used and, since a large number of invoices are entered at once, more timely payment of bills is possible. (*emphasis added*)

2) Mechanized Order Acknowledgment (MOA)
TelCordia Description: The engineer uses this report to confirm the vendor order.

The combination of the MOA and the detailed verified billing report is the mechanized version of a manual paper invoice from the vendor (emphasis added)

3) Detailed Verified Billing Report
TelCordia Description: This report lists *general invoice header information and detailed amounts for each invoice item verified without errors*. Invoice information on this report is sorted by association with the following hierarchy of field headings (dependent on the input parameters selected):

- *RCO, Accounting Area, Engineering Area, Account Location and Report Serial*
- *Authority*
- *Requisition*
- *Invoice Number, Invoice Date*
- *Vendor Order*
- *Vendor Spec*

(emphasis added)

If ASD had conducted a review of the internal control structure, in accordance with GAAS, such documentation would have been considered valid in their rescoring. Moreover, there is no Part 32 CPR requirement that specifies that a particular type of document should comprise the supplemental records which make up the CPR.[30]

Based on the standards contained within the Public Notice and Ameritech's review of the ASD's application of supplemental information provided by Ameritech, including the results of the reperformance verification conducted by AA, Ameritech submits that the ASD was neither complete nor consistent in their rescoring. Inconsistent

[30] See C.F.R. at 32.2000(f); See also SBC Response at Page 49.

rescoring, together with the other identified audit deficiencies, renders the audit results unreliable and the recommendations meritless. Again, this conclusion alone justifies an expeditious close to this proceeding.

Issue 3: To the extent the auditors' sampling, rescoring and other methodologies were valid, whether the degree of error in the CPR records determined by the auditors is sufficient to require corrective action.

Since ASD's sampling methodology, rescoring, and other audit methodologies are not valid, indeed deficient, the sufficiency of the degree of error to require any corrective action is a superfluous issue that has no practical relevance for this proceeding.

In any event, Ameritech's review and analysis shows that about 96 percent of the sampled items were found, which in the case of a going concern is not unreasonable and consistent with the ASD's results during 1994 audit of Ameritech where the preliminary conclusion reached was that nothing led the auditors to conclude that Ameritech was not in compliance with the Commission's CPR rules.

Lastly, a review of other independent analyses corroborates the deficiencies associated with the degree of error in the CPR records determined by ASD.[31] Therefore, no corrective action is necessary.

Issue 4: What accounting adjustments, if any, should be made to account for "missing" plant.

Given the identified deficiencies in the audit and statistical methodologies, no accounting adjustments or corrective actions are warranted or necessary. Moreover, a write-off is contrary to the Commission's rules which require that a retirement entry be referenced to the CPR from which the cost was obtained. Given that the proposed COE hardwire write-off is an extrapolated dollar amount, there is no such CPR reference justifying this action.[32] Additionally, the audit was not designed to arrive at specific state or study area results and such application is wholly inappropriate.[33]

In any event, any adjustment, would, at best, represent the correction of delayed retirements subject to normal retirement accounting. There is no justification for extraordinary retirements which would be contrary to Section 32.2000(g) (4) of the Commission's rules, which specifies, in part, that for a retirement to be considered extraordinary the retirement (i) will unduly deplete the depreciation reserve and, (ii) was not considered in setting past depreciation rates. Neither criteria is satisfied even assuming the audit process and results were correct.[34]

Issue 5: What accounting corrections, if any, should be used to resolve the Undetailed Investment identified in the audit reports:

No accounting corrections are necessary. The Audit Report's inclusion of this category of investment is an egregious error for several reasons and this investment category and associated recommendation to write-off $260.7 M of investment, should be stricken from the Audit Report. First, Undetailed Investment is a term that pre-dated divestiture. It represents used and useful investment that preceded the introduction of the mechanized Plug-In Inventory Control/Detailed Continuing Property Record (PICS/DCPR) system.[35] Ameritech has reduced the amount of this investment from

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[31] See SBC Response, Attachment B at Page 2; BellSouth Response at Pages 21-22; US West Response at Attachment 2; Bell Atlantic Response at Appendix A.
[32] See C.F.R. Section 32.2000(d)(1); See Ameritech Response at Page 17; See also SBC Response at Page 7; Bell Atlantic Response at Page 22; BellSouth Response at Page 8.
[33] See SBC Response at Pages 16-17.
[34] See Bell Atlantic Response at Page 23.
[35] See Ameritech Response at Pages 8-10; See also SBC Response at Pages 34-43.

$555 M as of December 31, 1993 to $138.8 M as of August 31, 1998, or a 75 percent reduction in less than five years. Ameritech plans to retire the balance of this used and useful functionary investment when appropriate.

Secondly, the alleged overstatement mistakenly includes $109 M of investment related to telecommunications plant with traffic Ameritech purchased from Sprint in 1997.[36] This purchase and authorization was approved by both the Federal Communications Commission (FCC) and Illinois Commerce Commission on October 15, 1997 and October 22, 1997, respectively. The purchase involved the provision of service over local exchange facilities for approximately 132,000 access lines.[37] Prior to the regulatory approval dates, in July 1997, assets were pre-loaded into Ameritech's operations support and provisioning systems, including the Undetailed Investment category of PICS/DCPR. Pre-loading was necessary to ensure that all investment could be monitored and maintained at the acquisition date to prevent service disruptions. No investment however, or related depreciation was recorded in Ameritech's financial records until the purchase date of the transaction on November 1,1997. The COE assets related to the purchase included two functioning central offices located in Des Plaines, Illinois and Park Ridge, Illinois. Ameritech is in the process of conforming the highly aggregated investment records received from Sprint to the FCC's CPR requirements.

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[36] See Ameritech Response at Page 9.

[37] See FCC Order and Certificate, released October 15, 1997, File No. W-P-C-7158, which granted Ameritech Illinois Metro, Inc., a wholly owned subsidiary of Illinois Bell Telephone Company, authorization to purchase and provide service over local exchange facilities that include approximately 132,000 access lines covering a small portion of northwest Chicago and all or portions of ten Illinois communities; See FCC Order, released October 15, 1997, DA 97-2200, granting Ameritech's request to revise their zone density pricing plan; See FCC Memorandum Opinion and Order, released October 22, 1997, file No. NSD-LM-97-29, granting Ameritech's request to include the exchanges purchased from Sprint to be included in the Chicago LATA; See FCC Memorandum Opinion and Order released October 23, 1997, AAD 97-100, granting Ameritech's request to include the exchanges purchased from Sprint in the Illinois study area boundaries; See State of Illinois –Illinois Commerce Commission Order, October 22, 1997, 97-0171, approving the purchase of the Sprint assets by Ameritech Illinois Metro, Inc. and granting Ameritech Illinois Metro, Inc. a Certificate of Service Authority; See State of Illinois- Illinois

Approximately 43 percent of the $109 M, or approximately $47 M, represents Plug-In investment that has been fully detailed as a result of a physical inventory. The remaining 57 percent, or approximately $62 M, represents hardwired equipment which Ameritech has removed from the Undetailed Investment category and is in the process of conforming to the FCC's CPR requirements with a planned completion date in 1999. In sum, it is incorrect for ASD to include the $109 M of assets purchased from Sprint in any kind of alleged overstatement of plant when this investment is used and useful functioning investment.

Additionally, the Audit Report asserts that Ameritech made a commitment to retire all the Undetailed Investment by the end of 1999 during the 1994 audit, but during the 1997 audit Ameritech reported that it planned to maintain a balance in this investment (See Audit Report at 12). The audit report fails to disclose that Ameritech reported it planned to maintain a balance in the near term because most of the remaining investment is associated with analog switches and the business case for the retention of analog switches changed in the intervening years between audits.[38] It makes no business sense to meet an arbitrary regulatory commitment when the underlying economic conditions changed the business case for the continued use of this investment. Ameritech has made a dramatic reduction in the amount of this investment and will continue to do so as the needs of the business dictate. In the interim, there is no corrective action necessary and this investment category and associated recommendation to write-off this investment should be stricken from the Audit Report.[39]

Commerce Commission, Order, August 26, 1998, 97-0675, approving the merger of Ameritech Illinois Metro, Inc. into Ameritech Illinois, with Ameritech Illinois as the sole surviving corporation.

[38] See Ameritech presentation to ASD on February 19, 1998.

[39] See Ameritech Response at Pages 9-10

Issue 6: **The recommendation of the auditors that the companies should be required to engage independent firms to perform an inventory of their entire central office equipment and provide the results to the commission, and that the Commission should analyze the results of the inventory and direct the companies to make necessary entries to correct their CPRs and account balances.**

A complete inventory of Ameritech's entire COE is unnecessary and would be a wasteful exercise because neither Ameritech's customers or shareholders would receive any benefit. Ameritech estimated that an inventory of its entire COE could take over five years at 700,000 hours and cost over $35 M. At best, a complete inventory is premature before resolving the issues in this proceeding and performing an evaluation of Ameritech's CPR practices, procedures, and controls.

Issue 7: **The recommendation of the auditors that, in order to improve the likelihood that the CPRs will be maintained correctly in the future, the companies should be required to engage independent auditors to review their practices, procedures, and controls for maintaining CPRs and to make recommendations for improving these systems so that the CPR plant balances can be maintained in compliance with the Commission's rules (parties should address the specific recommendations concerning the practices, procedures, and controls addressed by the auditors in the recommendations sections of the audit report).**

Ameritech is fully confident that its CPR practices, procedures, and controls are compliant in all material respects with the Commission's rules. As such, Ameritech is willing to discuss the engagement of an independent auditor to review such practices, procedures, and controls.[40]

[40] Ameritech Response at Page 18; See also BellSouth Response at Page 5.

Issue 8: **What ratepayer impact, if any, the alleged discrepancies in the CPR may have had, e.g. through the derivation of the Commission's price cap rates, including reinitialization of price caps, sharing, lower formula adjustments, exogenous cost calculations, and charges to or setting of the productivity factors, joint cost allocations, separations, access charges, and ultimately ratemaking.**

Since Ameritech operates in a price cap environment, any alleged discrepancies in the CPR would have had no impact on compliance with the Commission's rules or the rates Ameritech charged to customers-- either directly through the initialization of price caps, cost allocations, separations, access charges, or indirectly, through price caps with sharing, lower formula adjustments, exogenous cost calculations, or the price cap productivity factor. At worst, any CPR discrepancies would have been an be immaterial record-keeping matter reflecting delayed retirements which have no impact on the various financial and customer issues raised in the CPR NOI. There is no ratemaking impact principally because net investment (original cost of assets less accumulated depreciation) constitutes the rate base and a book retirement of an asset has no impact on net investment or rate base.[41]

As summarized below, Ameritech's Response demonstrated that there were no ratemaking implications as a result of the Audit Report's alleged findings. First, with respect to depreciation, the book retirement of an asset has no effect on the net investment, or rate base, because under the composite group method of depreciation accounting, the asset balance and the accumulated depreciation reserve are reduced by the same amount. Similarly, there is no impact on depreciation expense because the FCC

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[41] See Ameritech Response at Pages 12-16; See also BellSouth Response at Page 29; SBC Response at Attachment C; US West Response at Attachment 1; Declaration of Arthur Andersen at Pages 8-9; Bell Atlantic Response at Pages 13-17 and Exhibit 5, Affidavit of Ronald E. White, PH.D.; See also Affidavit of William E. Taylor in comments filed by the United States Telephone Association in this proceeding at Pages 11-16.

requires the use of remaining life depreciation which has a self-correcting mechanism. Since depreciation rates are not set each year, there may be some temporary under or overstatements of depreciation expense in a given year. These temporary under or overstatements do however, self-correct with the remaining life depreciation method.

Likewise, there is no impact on the calculation of the lower formula adjustment mechanism (LFAM) of 10.25 percent because earnings adjustments are determined from reported rate of return results. Since the rate base component of this return analysis is based on net investment, there is no impact from temporary unrecorded retirements as indicated above. In any event, with the adoption of the Commission's access reform order, the LFAM is eliminated when companies are granted pricing flexibility approval.[42] Similarly, depreciation expense has not been overstated, and earnings have not been understated, as a result of any delayed retirements.

With respect to the productivity factor for price cap companies, the current productivity factor is 6.5 percent consisting of a Total Factor Productivity (TFP) of 3.2 percent, an input price differential of 2.8 percent and a Consumer Productivity Dividend of 0.5 percent. Any alleged plant overstatement would impact the TFP since gross plant investment is an input. The impact however, would have been a lower TFP resulting in a lower productivity factor and higher access rates.[43]

Finally, with respect to joint cost allocations and separations, any temporary unrecorded retirements do not cause any significant shifts in either jurisdictional results or cost allocations. Inter or intrastate revenue requirements, for which separations has

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[42] See In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers, Petition of US West Communications, Inc. for Forebearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA, CC Docket No. 96-262, CC Docket No. 94-1, CCB/CPD File No. 98-63, CC Docket No. 98-157, Fifth Report and Order and Further Notice of Proposed Rulemaking, released August 27, 1999, at para. 166.

been used in the past, has been based on net book cost which does not change as a result of temporary unrecorded retirements. With respect to cost allocations, Ameritech's Cost Allocation Manual only uses relative investment in 10 out of 173 cost pools to apportion expenses. Again, as a result, there are no significant cost allocation shifts due to temporary unrecorded retirements.

In summary, any alleged discrepancies in the CPR -- even if the Audit Report results were correct --would have had no negative impact to ratepayers.

Issue 9: Whether the property record discrepancies have any impact on (1) calculations under the Telecommunications Act of 1996 relating to (a) universal service support and (b) pricing of unbundled network elements, and (2) the merits of "takings" claims and "stranded costs" recovery.

There is no impact on calculations relating to universal service support and the pricing of unbundled network elements.[44] With respect to the impact on universal service support, the components consists of the (i) High Cost Loop Fund, (ii) Dial Equipment Minute (DEM) Weighting, and (iii) Long-Term (LT) Support Payments. Ameritech does not receive any DEM Weighting and none of the companies subject to the ASD's CPR audits are eligible to receive LT Support Payments (See Data from USAC 1Q99 filing available at: http://www.fcc.gov/ccb/universal_service/quarterly_filings/1999q1/us ac4. xls). Thus, any alleged property record discrepancies have no impact on these funds.

Embedded costs per loop are being used on an interim basis in the determination of High Cost Loop Fund Support, where the calculation of the loop costs uses the Separations process to calculate a revenue requirement. The use of embedded costs however, does not impact High Cost Loop Support. Specifically, the return associated

[43] Any alleged plant overstatement would have resulted in a higher growth rate in capital resulting in a lower TFP factor.